Internal Revenue Service
memorandum

CC:TL:TS
CWILSON

date: 24 JUN 1988

to: Special Trial Attorney CC:NA
Theodore J. Kletnick

from: Acting Chief, Tax Shelter Branch CC:TL:TS

subject: Request For Technical Advice
[redacted]

This is in response to your request for technical advice dated April 21, 1988.

ISSUES:

1. Whether petitioner, a market maker on the Chicago Board of Options Exchange was at risk under I.R.C. § 465 in [redacted] for approximately $[redacted] of losses suffered in closing out the loss legs of his butterfly straddle transactions where the petitioner's unrealized gain on the gain legs of the straddle transactions had limited his maximum potential for loss to approximately $[redacted]?

2. Whether the Commissioner should argue that petitioner's method of accounting for butterfly straddle transactions in call options on publicly traded stock violates the clear reflection of income requirement of section 446?

CONCLUSIONS:

1. Petitioner was not at risk under section 465 for any amount greater than his maximum potential for loss from his straddle positions (i.e., the difference between the premiums paid and received, plus commissions).

2. While we agree that petitioner's method of reporting the subject transactions results in a material distortion of income, we believe that this abuse is most appropriately attacked under section 465(b)(4). Accordingly, we do not recommend that a section 446(b) argument be advanced in the subject case.

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FACTS:

Petitioner, [redacted], was a market maker on the Chicago Board of Options Exchange (CBOE) during the years in issue in this case. In [redacted] established positions in [redacted] stock options. In most cases, the options involved were "call" options.

[redacted] utilized a stock options trading strategy called "straddling". 1/ Straddling involves the purchase and sale of equal numbers of offsetting stock options in a selected stock.

In this case, the straddles established by [redacted] were "vertical" straddles. In a vertical straddle the date of expiration of both the short position (in which [redacted] was the seller of the option) and the long position (in which [redacted] was the purchaser of the option) are the same, but the exercise price, or "strike" price, varies between each leg of a straddle.

The idea underlying the vertical straddle trading strategy is that it reduces a taxpayers risk of economic loss because the value of the offsetting short and long legs of the straddle always move up or down together. Their values move up or down together because fluctuations in the price of the underlying stock have an opposite but equal affect on the value of both legs. Accordingly, any loss on one leg of the straddle will be offset by an equal gain on the other leg of the straddle. The only potential for economic gain or loss is within certain quantifiable parameters. The maximum potential for economic loss on a vertical straddle can never exceed the difference between the premiums paid and received plus commissions. The maximum economic profit can never exceed the difference between the strike prices, less the net premiums paid. less commissions. See Fox v. Commissioner, 82 T.C. 1001, 1013 (1984).

The risk of economic loss in a stock options straddle can be further reduced within the parameters discussed above through the use of "butterfly" straddles, as [redacted] did in this case. A vertical butterfly straddle requires the taxpayer to establish two straddles. In one example, the two short legs of each

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1/ From the information you submitted, we note that [redacted] also traded puts and balanced those puts with stock purchases. Our "at risk" analysis with respect to Issue 1 is confined to the stock option straddles.

straddle will have the same exercise price. The long leg of one of the straddles will have an exercise price below that of the short legs and the long leg of the other straddle will have an exercise price above that of the short legs. 2/

The two straddles that make up a butterfly straddle will move in opposite directions as the price of the underlying stock fluctuates, but they will both move approximately the same amount from where they started. Any gain or loss with respect to one straddle due to a change in the price spread will be offset by the gain or loss on the other straddle.

After [redacted] established his butterfly straddle positions, he engaged in several "switching" transactions. A "switch" occurs when a leg of a straddle is closed out and then a similar offsetting position with respect to the remaining leg is re-established. The purpose of re-establishing an offsetting position with respect to the gain leg by "switching" is to maintain the balanced position and reduced economic risk of a straddle.

[redacted] claimed a taxable loss on the full amount (approximately $[redacted]) of the closed out loss legs of his vertical butterfly straddles for taxable year [redacted], despite the fact that his actual economic risk of loss from the transactions as a whole was limited as described above. The gain leg of the straddle and the switch positions were then closed out in [redacted].

[redacted] was not required to put up margin for his transactions. [redacted] clearing firm imposed capital requirements of approximately $[redacted] from [redacted], however, with respect to the [redacted] options.

DISCUSSION

ISSUE 1:

Section 465(a) provides generally that in the case of an individual (and certain closely held corporations) engaged in any activity to which section 465 applies, any loss from the activity for the taxable year shall be allowed only to the extent of the aggregate amount with respect to which the taxpayer is at risk for the activity at the close of the taxable year. For the taxable years in issue, section 465(a) applied to all activities, including trading in stock options, except the holding of real property. I.R.C. § 465(c)(3).

2/ Sometimes the two short legs of each straddle are combined, as they were in many of [redacted] trades, into one short leg with twice the number of options as in either of the long legs.

In general, a taxpayer is considered at risk for the amount of money (or adjusted basis of property) that he has contributed to the activity. I.R.C. § 465(b)(1). Borrowed amounts are considered at risk, however, only to the extent the taxpayer is personally liable for repayment or to the extent of the fair market value of property not used in the activity that the taxpayer has pledged as security for the borrowed amount. I.R.C. § 465(b)(2). In this case, [redacted] was required to put up approximately $[redacted] capital to secure his [redacted] option positions. The balance of his obligations were apparently obligations for which he was personally liable to his clearing firm. Accordingly, [redacted] takes the position that he was fully at risk for the amount of the taxable loss he claimed in [redacted].

Regardless of the amount of money contributed to an activity or the nature of a taxpayer's liability for amounts borrowed with respect to an activity, however, a taxpayer is not treated as being at risk with respect to amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements or other similar arrangements. I.R.C. § 465(b)(4). The limitations of section 465 apply on the basis of the facts existing at the end of each taxable year. I.R.C. § 465(a)(1); S. Rep. No. 94-938, 94th Cong. 2d Sess. 48; 1976-3 C.B. (Vol. 3) 86. The question presented in this case is whether, despite the recourse nature of [redacted] obligations with respect to his stock options trading, he is protected against loss within the meaning of section 465(b)(4). We conclude that [redacted] was so protected and, as a result, his taxable losses for [redacted] were limited to his maximum potential economic risk of loss from the straddles as a whole. A review of the legislative history surrounding section 465 will assist in explaining this conclusion.

Underlying Congress' purpose in enacting section 465 was its belief that taxpayers should not be allowed to deduct losses in excess of the amount economically at risk in an activity.

> When an investor is solicited for a tax shelter activity, it has become common practice to promise the prospective investor substantial tax losses which can be used to decrease the tax on his income from other sources. The committee believes that it is not equitable to allow these individual investors to defer tax on income from other sources through losses generated by tax sheltering activities, to the extent the losses exceed the amount of actual investment the taxpayer has placed at risk in the transaction.
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> The opportunity to deduct tax losses in excess of the amount of the taxpayer's economic risk arises under present law primarily through the use of nonrecourse financing not only by limited partnerships, but also by

> individuals and subchapter S corporations. <u>The ability to deduct tax losses in excess of economic risk also may arise through guarantees, stop-loss agreements, guaranteed repurchase agreements, and other devices</u> used by partnerships, individuals and subchapter S corporations.
>
> Nonrecourse leveraging of investments <u>and other risk limiting devices which produce tax savings in excess of amounts placed at risk</u> substantially alter the economic substance of the investments and distort the workings of the investment markets. Taxpayers, ignoring the possible tax consequences in later years, can be led into investments which are otherwise economically unsound and which constitute an unproductive use of investment funds.

S. Rep. No. 94-938 at 47. (Emphasis added).

To prevent the deduction of taxable losses in excess of amounts economically at risk in an activity, Congress enacted section 465 and, in particular, section 465(b)(4) with respect to amounts protected against loss, nonrecourse financing, guarantees, stop loss agreements, or others similar arrangements. Congress explained the operation of section 465(b)(4) as follows:

> Also, under these rules, a taxpayer's capital is not "at risk" in the business, even as to the equity capital which he has contributed to the extent he is protected against economic loss of all or part of such capital by reason of an agreement or arrangement for compensation or reimbursement to him of any loss which he may suffer. Under this concept, an investor is not "at risk" if he arranges to receive insurance or other compensation for an economic loss after the loss is sustained, or if he is entitled to reimbursement for part or all of any loss by reason of a binding agreement between himself and another person.
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> ....
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> Similarly, if a taxpayer is personally liable on a mortgage but he separately obtains insurance to compensate him for any payments which he must actually make under such personal liability, the taxpayer is at risk only to the extent of the uninsured portion of the personal liability to which he is exposed. The taxpayer will be able to include in the amount which he has at risk any amount of premium which he had paid from his personal assets with respect to the insurance.

S. Rep. No. 94-938 at 49 and 50. (Footnote ref. omitted).

Although the legislative history of section 465 does not define specifically what is meant by the words "other similar arrangements," it does evidence concern with situations in which taxpayers are effectively immunized from any realistic possibility of suffering an economic loss even though the underlying transaction was not profitable. Porreca v. Commissioner, 86 T.C. 821 (1986). In making the determination whether a taxpayer is protected against loss, it is the substance of the transaction rather than the form that governs. Prop. Treas. Reg. § 1.465-1(b).

For example, in Capek v. Commissioner, 86 T.C. 14 (1986), investors in a coal mining tax shelter issued promissory notes to satisfy their liability for advanced royalty payments. The notes were recourse on their face, but the investors were entitled to receive "penalty" payments if coal was not mined in amounts sufficient to satisfy the notes. The taxpayers argued that they were, in fact, at risk because they were not required to use the penalty payments to offset their obligations on the notes. It is the effect of an arrangement that determines whether an amount is at risk under section 465(b)(4), however, according to the Court in Capek, and the effect was to protect the investors from any loss on the notes. Capek v. Commissioner, 86 T.C. at 52-53. The offsetting penalty payment provisions were, therefore, stop loss agreements or "other similar arrangements" within the meaning of section 465(b)(4).

Similarly, in Cooper v. Commissioner, 89 T.C. 84 (1987), the Court was faced with another form of protection against loss. Investors in Cooper purchased solar hot water heating systems. Certain of the investors had paid a portion of the purchase price with "recourse' notes. By prearrangement, the systems were leased for 7 years to a company that acted in cooperation with the promoter. No principal payments were due on the notes for that 7 year period and at the end of the lease the investors had a "put" option to require the lessee to purchase the systems for the balance due on their notes. Cooper held that those investors were protected against economic loss through a "guarantee, stop loss agreement or other similar arrangement" under section 465(b)(4) by virtue of the put option.

In this case, too, [redacted] was effectively immunized from any risk of economic loss in excess of the maximum potential for loss inherent in his straddle positions. That was the conclusion of the Court in Fox v. Commissioner, 82 T.C. 1001 (1984) in which the Court was faced with a taxpayer, like [redacted], who had established option straddles, then closed out the loss legs in one year, reestablished his offsetting positions through switches and closed out the gain legs of the straddles in the following year. Although the Court's disposition of the case on the grounds that the taxpayer in Fox lacked the requisite profit motive under section 165(c)(2) made it unnecessary to reach the Service's argument with respect to section 465, the Court made clear that the taxpayer was protected against loss within defined parameters:

> The maximum profit potential and maximum loss potential of a particular vertical option spread [straddle] is always readily quantifiable. The maximum loss on a spread will be the difference between the premiums paid and received plus commission. The maximum profit will be the difference between the strike prices, less the net premiums paid, less commissions.

Fox v. Commissioner, 82 T.C. at 1013.

The _Fox_ Court went on to state that:

> These tax straddling options transactions can hardly be said to number among congressionally approved, sanctioned, or encouraged responses to the tax laws. We need not even look to the subsequently enacted anti-tax straddling legislation for support. We need only look to the policies and history of section 165(c)(2) to see that transactions such as these, in which paper losses enormously exceeded the amounts actually at risk, were utterly outside the contemplation of Congress. 21/
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> 21/ Cf. sec. 465. (Balance of footnote quoting S. Rep. 94-938 at 47 regarding Congress' concern with the deduction of amounts in excess of the amounts economically at risk which is quoted above is omitted).

Fox v. Commissioner, 82 T.C. at 1025.

Thus, we conclude that, like the taxpayer in _Fox_, [redacted] was protected against economic loss by the nature of his straddle positions. His purported "loss" was always offset at least up to the amount of his maximum potential for loss by his unrealized gain on the gain legs of his straddle options (which gain was protected by his switch positions once the loss legs were closed out). Like the taxpayers in _Cooper_ who could always avoid having to personally satisfy their notes by offsetting their obligations with the guaranteed gain from exercising their put options, [redacted] could always avoid having to personally satisfy his obligations on the loss legs of his straddles by offsetting those obligations with the guaranteed gain from closing out the gain legs of his straddle options.

This conclusion is consistent with the Court's decision in Melvin v. Commissioner, 88 T.C. 63 (1987) where the Court stated that with respect to section 465, the critical inquiry should be to determine who is the obligor of last resort, and in determining who has the ultimate economic responsibility for the loan, the substance of the transaction controls. That determination is made in the context of the worst case scenario. Melvin v. Commissioner, 88 T.C. at 75. As stated above, the worst case scenario for [redacted] is that his loss will reach his maximum potential for loss of the difference between the premiums paid and received plus commissions. [redacted] will never bear ultimate economic responsibility for the balance of his obligations with respect to the loss legs because those obligations will always be offset by his gain on the gain legs.

[redacted] protection against having to bear ultimate economic responsibility for any loss in excess of the maximum potential for loss inherent in his straddle positions can also be viewed as equivalent to purchasing insurance. The premiums paid and received by [redacted] for his straddle positions ensure that any loss he suffered on one leg would be offset by gain on the other leg. No other result was possible. As noted in S. Rep. 94-938 at 49 and 50 (quoted above), a taxpayer is not "at risk" if he arranges to receive insurance or other compensation for an economic loss after the loss is sustained, or if he is entitled to reimbursement for part or all of any loss by reason of a binding agreement between himself and another person. While an offsetting gain on the gain leg of a straddle is not "insurance" in the strict sense of compensation for the prior loss, it is in every practical sense equivalent in effect -- [redacted] was protected from bearing ultimate economic responsibility for any loss in excess of a quantifiable amount. As the Court has stated, it is the effect of an arrangement that determines whether an amount is at risk under section 465(b)(4)." Capek v. Commissioner, 86 T.C. at 51-52.

In addition to the foregoing, additional support for our conclusion that [redacted] amount at risk was limited by his straddle positions can be found in the proposed Treasury regulations under section 465. Prop. Treas. Reg. § 1.465-1(b) states:

> In applying section 465 and these regulations, substance will prevail over form. Regardless of the form a transaction may take, the taxpayer's amount at risk will not be increased if the transaction is inconsistent with normal commercial practices or is, in essence, a device to avoid section 465. See § 1.465-4 for rules regarding attempts to avoid the at risk provisions.

Section 1.465-4(a) of the proposed regulations provides that:

> If a taxpayer engages in a pattern of conduct which is not within normal commercial practice or has the effect of avoiding the provisions of section 465, the taxpayer's amount at risk my be adjusted to reflect more accurately the amount which is actually at risk.

It is apparent that [redacted] practice of consistently closing out the loss legs of his straddles in [redacted], immediately followed by switching to similar positions, while holding the gain legs open until [redacted] had no valid non-tax business purpose. Any advantage he could have gained by closing out the loss legs and holding the gain legs open with the hope that the gain would increase was lost when he switched to positions similar to those of the loss legs he had just closed. The switches not only reestablished a cap on his potential for profit, they further reduced his overall potential for profit from the transactions by increasing his transaction costs from implementing the switches. As a result, it is clear that [redacted] consistent pattern of trading was aimed at maintaining his limited economic risk through the switches while creating the appearance of large tax losses rather than increasing his potential for profit. Such a pattern of trading cannot fairly be characterized as normal commercial practice. It is instead merely a device to avoid section 465.

Where a pattern of conduct lacks a business purpose, is not within normal commercial practice and is intended merely to avoid the limitations under section 465, a taxpayer's losses are limited to the amount he is actually and economically at risk. Larsen v. Commissioner, 89 T.C. 1229, 1275 (1987); Offerman v. Commissioner, T.C. Memo. 1988-236; Prop Treas. Reg. § 1.465-4(a). Accordingly, [redacted] losses from his straddle transactions are limited to his maximum potential for economic loss inherent in his straddle positions.

ISSUE 2:

Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. Section 446(b) states that if the method of accounting used by the taxpayer does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

Certain principles of law concerning section 446(b) are undisputed and are easily stated. The Commissioner has broad powers and discretion to determine whether accounting methods employed by a taxpayer clearly reflect income. Commissioner v. Hansen, 360 U.S. 446 (1959); Mooney Aircraft, Inc. v. United States, 420 F.2d 400 (5th Cir. 1969). Courts will not overturn the Commissioner's determination unless the evidence clearly shows that he abused his discretion. Standard Paving Co. v. Commissioner, 190 F.2d 330 (10th Cir.), cert. denied, 342 U.S. 860 (1951); Schram v. United States, 118 F.2d 541 (6th Cir.), cert denied, 314 U.S. 695 (1941). The taxpayer has a heavy burden of proof in establishing that the Commissioner abused his discretion. Photo-Sonics, Inc. v. Commissioner, 357 F.2d 656 (9th Cir. 1966). Although a taxpayer's consistent use of a method of accounting is an important factor in determining whether that method clearly reflects income, United States v. Mitchell, 271 U.S. 9 (1926), the consistent use of a method of accounting that does not clearly reflect income can be rejected by the Commissioner. Cotton v. Commissioner, 25 B.T.A. 866 (1932), acq. XI-1 C.B. 2.

The application of the above principles to specific factual situations, especially in the context of the cash basis taxpayer, is complicated by the fact that, though the clear reflection of income requirement has been in existence since the Revenue Act of 1916, 39 Stat. 756 § 8(g), a concise definition of "clear reflection of income" has not developed. The Tax Court stated in Lewis v. Commissioner, 65 T.C. 625, 629 (1975):

> Existing authority does not define precisely what constitutes a material distortion of income, but such a distortion is likely to be found when the amount of an interest expense item is substantially in excess of what might normally be expected in an arm's length transaction structured without special regard to tax consequences.

Other cases addressing the distortion of income question have stressed the taxpayer's conformance to generally accepted accounting principles. See, e.g., Schlude v. Commissioner, 372 U.S. 128 (1963); Fort Howard Paper Co. v. Commissioner, 49 T.C. 275 (1967); Advertisers Exchange, Inc. v. Commissioner, 25 T.C. 1086, (1956), aff'd per curiam, 240 F.2d 958 (2d Cir. 1957). However, most cases construing section 446(b) have dealt either with advance payments received by accrual basis taxpayers, see, e.g., Schlude v. Commissioner, supra; Boise Cascade Corp. v. United States, 530 F.2d 1367 (Ct. Cl.), cert. denied, 429 U.S. 867 (1976); prepaid expenses of cash basis taxpayers, see, e.g., Sandor v. Commissioner, 62 T.C. 469 (1974), aff'd per curiam, 536 F.2d 874 (9th Cir. 1976), or the inventory method of accounting. See, e.g., All-Steel Equipment, Inc. v. Commissioner, 54 T.C. 1749 (1970).

As noted above, setting standards for the clear reflection requirement is particularly difficult as regards the cash basis method of accounting as this method is inherently distortive in the sense that it diverges from generally accepted accounting principles. Indeed, this inherent distortion led the Ninth Circuit to conclude in Osterloh v. Lucas, 37 F.2d 277, 278 (9th Cir. 1930) that clear reflection of income only requires that books be kept fairly and honestly.

As discussed more fully in Reconsideration of Rev. Rul. 58-162, G.C.M. 38034, I-235-76 (August 7, 1979), the Service has adopted a two-fold approach in applying the clear reflection requirement to a cash basis taxpayer.

The first approach is the "matching" or "transactional" analysis. Ideally, section 446(b) requires the matching of income earned in a given year with the expenses incurred in the earning of that income. "The key to validity of an accounting method is, in accounting terms, a matching of costs and revenues and, in terms of the taxing statute, a clear reflection of income". Photo-Sonics, Inc. v. Commissioner, supra, at 657. This approach underlies Rev. Rul. 68-643, 1968-2 C.B. 76, to the extent that it deals with the deduction of prepaid interest for periods of less than twelve months beyond the end of the taxable year, and Rev. Rul. 79-229, 1979-2 C.B. 210, which deals with the deduction of prepaid feed to be used in the subsequent taxable year. Under the matching approach, the taxable year for reporting items of income must correspond to the taxable year in which the related deductions are properly claimed.

Rev. Rul. 79-229, supra, discusses factors to be considered in applying the "matching" approach in the context of prepaid feed expenses. These factors include: the useful life of resulting assets; the relationship of the amount of the prepaid expense to the projected magnitude of the business in a subsequent year, see Cole v. Commissioner, 64 T.C. 1091 (1975) aff'd 586 F.2d 747 (9th Cir. 1978) cert. denied 441 U.S. 924 (1979); the materiality of the expenditure in relation to the taxpayer's income for the year, Clement v. United States, 580 F.2d 422 (Ct. Cl. 1978); the purpose for paying in advance, Baird v. Commissioner, 68 T.C. 115 (1978); the customary, legitimate business practice of the taxpayer in conducting livestock operations; the amount of the expense in relation to past purchases, and the time of the year the expenditure was made; and whether the taxes paid by a taxpayer consistently deducting prepaid feed costs over a period of years are reasonably comparable to the taxes that would have been paid had the same taxpayer consistently not paid in advance.

The second approach is the capital expenditure analysis. This approach is derived from Treas. Reg. § 1.461-1(a)(1) which states, in part:

> If an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made.

It is the capital expenditure approach which was sustained in Burck v. Commissioner, 533 F.2d 768 (2d Cir. 1976) and Sandor v. Commissioner, supra.

The capital expenditure analysis is not applicable in the subject case, as the loss leg of petitioner's straddle cannot be said to have created a capital asset, and thus cannot be raised.

We recommend that the remaining analysis, the "matching" or "transactional" approach, not be advanced for several reasons. First, there is some judicial resistance to the "matching" or "transactional" approach to clear reflection of income in the context of a cash basis taxpayer. See Cravens v. Commissioner, 272 F.2d 895, 900-901 (10th Cir. 1959) Cole v. Commissioner, supra, at 1106-1110. Secondly, the transactional approach has already been rejected by the Tax Court in the context of commodity straddles. See Smith v. Commissioner, 78 T.C. 350, 385-390 (1982), aff'd, 820 F.2d 1220 (1987) wherein the court refused to match the taxpayer's offsetting commodity straddle positions. Thirdly, given this adverse precedent, the transactional analysis is best raised in the context of a statute which specifically contemplates a transactional approach, i.e., section 465(b)(4). Section 465 is clearly directed at the present abuse and contemplates the use of a transactional analysis, i.e., amounts purportedly at risk are to be matched against protection from loss.

While we agree that petitioner's reporting of the subject transactions constitutes a material distortion of income within the meaning of section 446(b) of the Code and do not recommend concession of this issue, we conclude that it is better not to advance an argument which, on these facts, has little likelihood of success, when the same argument has a much higher probability of success as an at risk argument. Under these circumstances, the clear reflection argument can only serve to undercut the at risk argument.

/s/ Pamela Gibson

PAMELA V. GIBSON